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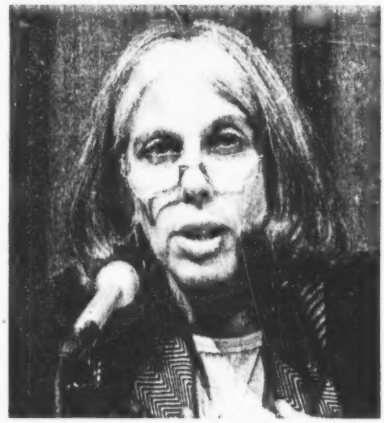
Seminar Panelists Discuss Ways and Means to Reform Military Spending

Do bilateral donors and multilateral agencies have the responsibility, and the means, to press countries that receive aid to reduce the level of their military expenditures? A recent Economic Forum seminar, sponsored by the IMF Visitors' Center, explored this and related questions with panelist Nicole Ball, a visiting fellow at the Overseas Development Council; Russell Kincaid, Chief of the IMF's Special Facilities and Issues Division of its Policy Development and Review Department; and Pierre Landell-Mills, Senior Policy Adviser in the World Bank's Office of the Director, Technical Department of the African Region. Shailendra Anjaria, Director of the IMF's External Relations Department, chaired the discussion.



Ball: military expenditures have significant economic costs.

Tools and Next Steps

It is now widely recognized, Ball noted, that significant economic and political costs attend high levels of military expenditures. The end of the cold war; the evident dangers of unrestrained arms sales and technology transfers (made graphic by the Middle East conflict); and the deep and prolonged economic crisis in many developing countries have all prompted donor and recipient countries, she said, to re-evaluate the efficacy of military expenditures. A once taboo topic is increasingly arising in discussions between developing countries and bilateral and multilateral lending institutions. Donors, notably Germany and Japan, have begun to link aid disbursements to the behavior of the military sector, and recipient countries have in some instances sought bilateral and multilateral assistance in converting defense industries and demobilizing armies.

Drawing on her recently published study, *Pressing for Peace: Can Aid Induce Reforms?*, Ball concentrated on two aspects of the debate: the tools available to bilateral and multilateral agencies and the steps that they might take in the near future. *(Please turn to page 374)*

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Mexico's Comprehensive Structural Adjustment Over Past Decade Described in IMF Study

Since the late 1980s, Mexico has markedly changed its economic structure and improved its financial performance. Consequently, its rate of inflation has fallen sharply, financial savings have risen rapidly, and its balance of payments position has strengthened. In *Mexico: The Strategy to Achieve Sustained Economic Growth*, edited by IMF economists Claudio Loser and Eliot Kalter, members of an IMF staff team examine several aspects of Mexico's structural reform effort and its results.

In the study's introduction, the editors explain that "Mexico's experience . . . was not the result of a rapid policy fix but the consequence of a persistent, courageous, and difficult process of adjustment that started at the beginning of the 1980s and was intensified in subsequent years." They note that while the success of Mexico's structural adjustment program is due primarily to the efforts of the Mexican authorities, undertaken with the cooperation of the Mexican people, the country also received considerable outside assistance from multilateral financial institutions (including the IMF), the governments of creditor countries and their agencies, and commercial banks.

IMF involvement in the Mexican authorities' efforts to achieve structural reform has been reflected in Mexico's extended arrangement of 1982–85; its stand-by arrangement of 1986–88; and its extended arrangement of 1989–93. The seven contributors to *Mexico: The Strategy to Achieve Sustained Economic Growth*, which is the IMF's Occasional Paper No. 99, are IMF economists who have participated in the process of cooperation between the IMF and Mexico over the last five years.

***Claudio Loser (left) and Eliot Kalter, editors of* Mexico: The Strategy to Achieve Sustained Economic Growth.**

Overview

In a chapter that sketches out the highlights of Mexico's efforts to achieve sustainable growth through structural adjustment, Eliot Kalter of the Policy Development and Review Department notes that the authorities adopted significant financial and structural measures, with special emphasis on tightening fiscal policy, to address the situation that existed after the debt crisis erupted in 1982. He observes that "this policy stance was not comprehensive, however, and the fiscal effort was insufficient to bring back confidence to financial markets. In the context of high public sector debt, accelerating inflation, and rising interest rates, interest payments rose substantially in relation to gross domestic product (GDP), and the overall public sector deficit remained high. Private sector confidence in government remained low and economic activity was stagnant."

"It became apparent," Kalter continues, "that a more comprehensive effort was required . . . . Thus, in December 1987, the authorities introduced an economic program, reinforced in late 1988, that is based on five key elements: tight financial policies; an incomes policy; significant structural reform; innovative support from the international financial community: and the implementation of policies aimed at protecting the economy from adverse shocks."

This strategy has been quite successful: for example, the 12-month rate of inflation fell from 159 percent in December 1987 to 19 percent in Decem-

ber 1991, and—after years of stagnation—real GDP grew by roughly 4 percent annually in 1990 and 1991. The study also notes that, reflecting strong private sector capital inflows, the overall balance of payments for 1991 was US$7 billion in surplus; additionally, the overall public sector borrowing requirement (PSBR) declined from 16 percent of GDP in 1987 to 1.5 percent in 1991.

Fiscal Policy

During 1982–87, the authorities' financial policies were tight and placed special emphasis on fiscal adjustment. They bore fruit, as evidenced by the movement in Mexico's primary fiscal balance (which is computed by taking the sum of all revenues of the government and then subtracting all government expenditures except interest payments) from a deficit of 5 percent of GDP in 1982 to a surplus of 5 percent in 1987. Nonetheless, spiraling inflation and high interest rates offset most of the effects of this strong fiscal effort, with the result that the PSBR declined by only 1 percent—to 16 percent of GDP from 17 percent—during 1982–87.

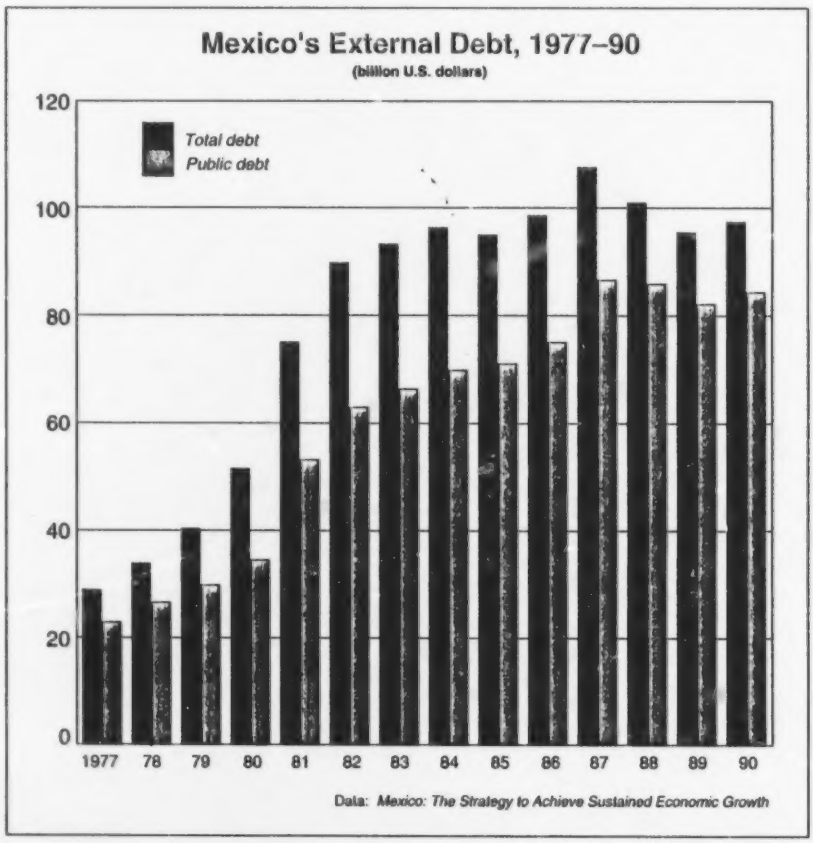
After the 1982 debt crisis, Kalter observes, the authorities' ability to reduce the size of the PSBR was hampered by the large numbers (roughly 1,100 in 1982) of public sector enterprises (many of which operated inefficiently), structural impediments to adjusting public sector revenue and expenditure, and the adverse impact of the large existing domestic debt. To surmount the above-mentioned difficulties, the Mexican authorities further strengthened fiscal policy at the level of the primary fiscal balance and implemented structural fiscal reforms. Non-interest current and capital expenditures by public enterprises were reduced, with the reductions in capital expenditure shared between the federal government and public enterprises. The authorities also emphasized the divestiture (privatization) of public enterprises, with the result that their number declined from 1,100 in 1982 to 420 by the end of 1988 and to fewer than 250 by the end of 1991. This policy, Kalter states, "has allowed the public sector to concentrate its limited resources on priority sectors and has allowed the private sector to participate in the development of critical areas of the economy."

In 1987, the authorities implemented a major reform of the tax system to correct economic distortions, especially the effects of high inflation, and to enhance Mexico's external competitiveness (by harmonizing its domestic tax system with those of other countries). During 1989–90, they supplemented this reform by broadening Mexico's tax base and reducing its marginal tax rates.

Incomes Policy

Mexico's incomes policy had two distinct parts: (1) an economic solidarity pact among government, business, and labor "to control prices and wages within the context of the Government's overall program aimed at economic recovery," and (2) a government spending program "aimed at eradicating extreme poverty and better integrating the poor into the process of economic recovery."

Under the Pact for Economic Solidarity (PACTO) of December 1987, the minimum wage, the controlled ex-



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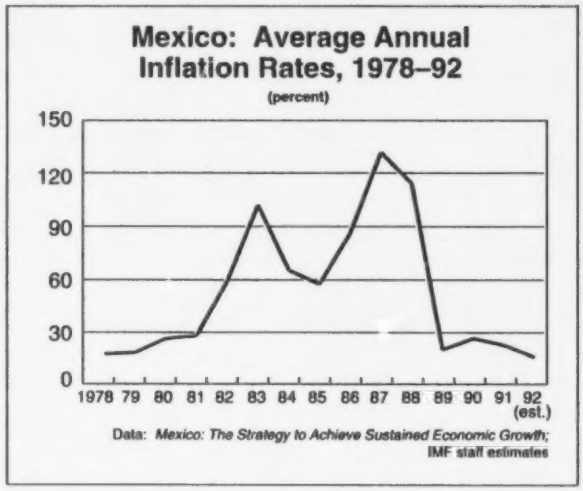
change rate, and public sector prices and tariffs were, after an initial adjustment period, frozen throughout 1988. In December 1988, the Pact of Economic Growth and Stability (PECE) adjusted minimum wages and public sector prices and tariffs, and specified that the valuation of the peso was to be determined by a preannounced schedule of depreciation against the U.S. dollar. Subsequently, the authorities have extended the PECE at "unannounced, although fairly regular, intervals."


Mexico: Average Annual Inflation Rates, 1978–92
(percent)
150
120
90
60
30
0
1978 79 80 81 82 83 84 85 86 87 88 89 90 91 92 (est.)
Data: Mexico: The Strategy to Achieve Sustained Economic Growth; IMF staff estimates

Kalter comments that "in combination with tight financial policies, the wage-price pact has aided in reducing inflation." The nominal rate of increase of minimum wages has fallen as inflation has decreased; the economy's adjustment to public sector prices and tariffs has met the authorities' targets; and the magnitude of preannounced downward adjustments of the dollar/peso rate has steadily decreased.

The second part of the Government's incomes policy, the Program of National Solidarity (PRONASOL), was initiated in 1989. It emphasizes programs "to expand and strengthen programs in education, nutrition, and health, as well as those related to the provision of drinking water, sewage, and electricity." In order to control costs, it seeks to avoid the use of broad subsidies; its programs are targeted specifically to help those Mexicans living in extreme poverty. The various programs are decentralized, with considerable input received from the affected local communities. The amount of government funds targeted for programs within PRONASOL has increased significantly since its inception, and, Kalter observes, this "has helped improve social equity while Mexico undergoes its economic stabilization program."

Structural Reforms

The study notes that, as part of its economic reform program, Mexico has moved to liberalize its external trade and investment policies, to enter into free trade arrangements, to liberalize and privatize its financial system, and to deregulate specific economic activities.

In 1985, Mexico began dismantling its tariff and nontariff barriers, which had been designed to support its previous policies of import substitution and reliance on oil exports for the earning of a large proportion of necessary foreign exchange. In August 1986, it joined the General Agreement on Tariffs and Trade (GATT), and, in 1989, foreign investment regulations were liberalized: the procedures for government authorization of investment projects were simplified; limits on foreign ownership were relaxed; and some barriers to the entry of foreigners into the Mexican stock market were reduced.

The study comments that "the implications of this transformation [of Mexico] into a highly open economy have been significant as the incentive structure has been reoriented while major distortions have been removed, leading to greater efficiency. Export growth has picked up, and exports have been diversified." It also notes that Mexico is currently negotiating four free trade agreements, including the North American Free Trade Agreement (NAFTA) with the United States and Canada; an Agreement of Economic Complementarity with Chile; another Agreement of Economic Complementarity with Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua; and a plan to establish a free trade zone with Colombia and Venezuela.

"Until the late 1980s," Kalter points out, "despite a period of gradual transformation and liberalization, the financial system in Mexico was characterized by interest rate restrictions, domestic credit controls, high reserve requirements, and fragmented financial markets causing inefficiencies in the intermediation between borrowers and lenders. Capital markets were not well developed, and firms often had to turn to informal markets."

During 1988–89, the Mexican authorities freed interest rates and eliminated direct controls on credit "to enhance efficiency through greater reliance on market forces, to promote the growth and deepening of financial markets, and to improve the effectiveness of monetary policy." Kalter also observes that "the cornerstone of the institutional reform was the reprivatization of Mexico's commercial banks [which had been nationalized in 1982], . . . which was part of a wider plan to promote financial integration through a universal banking system"—that is, a banking system that permits banks to both accept deposits

and engage in securities transactions.

The authorities also took steps to deregulate specific sectors of the Mexican economy—including transportation, communication, petrochemicals, fisheries, and agriculture—to make them more responsive to market forces and open them up to foreign investment.

International Financial Support

During 1982–87, the study notes, Mexico repeatedly rescheduled its debts to both commercial banks and official bilateral creditors while simultaneously undertaking adjustment programs designed to achieve macroeconomic stability. Nonetheless, Mexico's total external debt grew from US$75 billion (45 percent of GDP) at the end of 1981 to US$101 billion (57 percent of GDP) at the end of 1988. Consequently, Kalter comments, "concern about the impact of the external debt burden led in 1989 to support from the international financial community that emphasized debt and debt-service reduction."

In May 1989, the IMF approved a three-year extended arrangement (subsequently extended for a fourth year) with Mexico under which it made about US$3.6 billion available to the country, roughly US$1.0 billion of which was earmarked for the support of debt- and debt-service-reduction operations. Shortly afterward, the Paris Club of official bilateral creditors agreed to reschedule US$2.6 billion of Mexico's bilateral debt falling due during the following three years. In June 1989, the World Bank approved sectoral loans to Mexico totaling close to US$2 billion, of which US$760 million was earmarked for debt- and debt-service-reduction operations, and agreed to provide additional loans averaging US$2 billion during the subsequent three years. In January 1990, the World Bank approved an additional US$1.3 billion to support debt- and debt-service-reduction operations.

In March 1990, Mexico and its commercial bank creditors agreed on a multiyear financing package that "would involve debt- and debt-service-reduction operations sufficient to produce a substantial decline in the country's external debt."

Because of the support provided by the international community, Mexico's total external debt declined from 57 percent of GDP in 1988 to an estimated 39 percent in 1991, with public sector external debt declining from 49 percent of GDP to 31 percent during the same period. "This decline in external debt and debt service," the study comments, "has contributed importantly to the improved confidence in the economy and has been reflected in Mexico's return to a voluntary access to foreign capital."

Cushioning External Shocks

The Mexican authorities have attached considerable importance to protecting the economic gains derived from structural adjustment against possible adverse shocks. Kalter explains that "the strategy has included prearranging external assistance to compensate for unexpected events, while adjusting economic policies, saving windfall gains resulting from favorable exogenous [external] shocks, and restructuring the economy to minimize the impact of future shocks."

The adoption of contingencies began with Mexico's 1986–88 stand-by arrangement with the IMF. The country's adjustment program linked some of the program targets and the amount of the required external financing package to international oil price developments: if the oil price dropped below a certain point, additional external financing would be made available and domestic policies would be adjusted as necessary. Also, the same stand-by arrangement contained a mechanism that was to provide increased external financing for Mexico's public sector investment if the country's economy did not grow by the amount targeted under the adjustment program. The study notes that this strategy of protecting the Mexican economy against external shocks was further developed in Mexico's 1989–93 extended arrangement with the IMF.

The corresponding concept of saving windfall gains was also introduced in the 1986–88 stand-by arrangement. Under it, Mexico specified that higher-than-anticipated oil prices would result in its increased accumulation of international reserves and would reduce domestic financing for the public sector deficit. This concept, too, was embodied in the 1989–93 extended arrangement.

Additionally, the Mexican authorities have endeavored, with considerable success, to reduce the economy's vulnerability to oil price fluctuations by diversifying its export base: nonpetroleum exports increased from 25 percent of total exports in 1982 to an estimated 75 percent in 1991. They have also sought to better insulate the economy against the effects of international interest rate increases by means of the 1990 agreement with Mexico's commercial bank creditors and to provide Mexico with further protection against oil price fluctuations by actively trading in financial options (that is, in puts and calls in the options market for oil).

Copies of *Mexico: The Strategy to Achieve Sustained Economic Growth* are available for US$15.00 (US$12.00 for college or university faculty members and students) each from Publication Services, Box S-360, International Monetary Fund, Washington, DC 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

Military Spending Raises Difficult Issues

(continued from front page) Ball suggested that lending institutions have a broad array of tools at their disposal—an array sometimes misleadingly lumped together under the broad rubric "conditionality." The mechanisms available to lending institutions wishing to broach the subject of military expenditures are many, subtle, and varied. They include policy dialogue, financial and technical support, rewards for good behavior, efforts to set expenditure and performance targets in nonmilitary areas (which can imply reductions in military aid), and encouraging countries to make the military sector subject to the same standards of accountability and transparency that apply to civilian sectors.

Kincaid: the basic objective is to reduce military expenditures not national security.

Explicit conditionality, which offers economic benefit in exchange for a recipient country's clear willingness to undertake or abstain from certain actions, is another approach. But Ball favored a negotiated approach, contending that tools rooted in discussion and in a country's recognition of the need to change offered the best hope of sustained reform.

What broader steps are needed to encourage countries to examine their military expenditures? She urged lending institutions to take the following four steps:

- Create an enabling environment. Ball recommended neither withholding assistance nor waiting passively for change. The better course, she said, would be for lending institutions to assume an activist stance and to open discussions with borrowing countries on the need for reform.
- Coordinate policies among lenders. The more lenders seeking change, Ball argued, the more likely it would be that their advice would be taken seriously and the easier it would be to fund reforms.
- Establish common security-related criteria. Recipient countries should be asked to conform with existing international treaties, agreements, and accepted standards of behavior.
- Acknowledge that reform is a two-way street. It should be undertaken not only by aid recipients but also by major arms suppliers.

Although Ball focused her remarks on the leverage lending institutions have in promoting reform, she emphasized that "ultimately it is the people and governments in developing countries that will make the decision."

Caveats

Although the aid community largely agreed on the broad need for, and the importance of, reduced military expenditures, much less unanimity existed, according to Kincaid, on underlying questions. He assumed the role of devil's advocate to pose questions about the complex issues surrounding any reduction in military expenditures. He grouped these issues into three broad categories: the multilateral security that must precede any reduction, basic definitional questions, and coordination concerns.

Multilateral arrangements. "The basic object," Kincaid said, "is not to reduce national security but to reduce expenditures." Lending institutions will not be in a position to change lending patterns until collective security—and collective security that is perceived to be effective and credible by the parties concerned—replaces a reliance on individual security arrangements, he said. But who will play global policeman? And how will this function be financed? And how will the most vexing of conflicts—such as those that have erupted in Cambodia, Somalia, and Yugoslavia—be dealt with, since they call into question the most basic nature of a sovereign nation state?

Definitions. "Excessive" military expenditure is difficult to define, according to Kincaid. The IMF is not in a position to assess security needs, he said, but it can assess the opportunity costs of military spending versus other spending if the appropriate comparative data is available. For many developing countries, however, military spending takes place outside the national budget and beyond the scrutiny of a parliament. Informed debate will be difficult within these countries and between donors and recipients until these countries achieve greater transparency in their data and their decision-making processes. And even where appropriate data exist, questions of definition will persist, Kincaid noted. How will the analyst treat dual use forces, such as the police or national guard, and dual functions, such as military hospitals that treat both military personnel and civilians?

Donor coordination. Donors, Kincaid

observed, have many objectives, and setting priorities even within an agency can be difficult. How will a reduction in military expenditures rank among their priorities? Will it be more or less important than poverty or the environment, for example? Are lending agencies asking too much of developing countries in too many areas? And when the major arms importers are not aid recipients (for example, Iran, Iraq, Libya, and Saudi Arabia), is aid the appropriate tool for pursuing reduced military spending? Do countries that export arms need to practice self-restraint or is there a need to focus on general international rules related to arms transfers?

Kincaid concluded by discussing the IMF's approach, which has been to seek comprehensive data, including military expenditures, in its regular consultation with all member countries. Where a country's level of, or changes in, military spending is large —with macroeconomic or structural implications—then the IMF has focused on military spending in the Article IV consultation discussions.

The IMF, Kincaid added, emphasizes persuasion rather than formal linkage of its lending. "For the IMF," he noted, "the question is still whether the macroeconomic policies in their entirety are appropriate in the country's circumstances."

Moral Imperative

Landell-Mills argued the "absurdity of a world that spends 5 percent of its GDP on military expenditures . . . when there are more than 600 million people in absolute poverty." More breathtaking, he argued, is that the commitments made by the U.S. Government last year to sell $23 billion in arms to Third World governments whereas net official aid transfers to Africa—from all sources—amounted to only $9 billion. He also queried the "irrational and seemingly indefensible differences" between countries' levels of military expenditures. Why, he asked, does Ghana spend 0.6 percent of its GDP on military expenditures and Tanzania, 4.1 percent? Or why, for that matter, would Austria spend 1.1 percent and Portugal 3.3 percent?

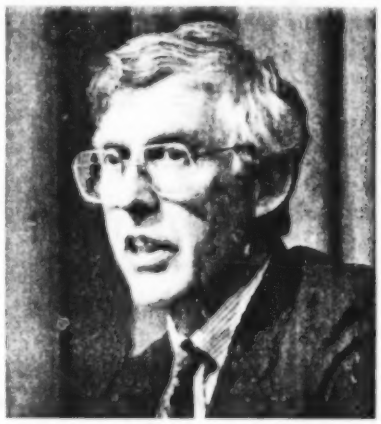
Over the past ten years, Landell-Mills noted, the Bank has expressed concern at the level of military expenditures in at least twenty cases. It was assisting countries that wished to convert military-industrial complexes to civilian uses and to demobilize large armies. The Bank currently has two research projects on topics related to military expenditures—one on the economic implications of the transition from war to peace, and the other on the best ways to downsize armies.

Landell-Mills stressed it was not the Bank's role to raise political and security considerations with its member countries. He felt it was appropriate, however, for the Bank to question the countries' allocating public expenditure for nonproductive purposes and to consider whether they were adequately addressing economic and social needs. Bilateral lenders, particularly through donor consultative groups, would lead the way in directly questioning levels of military expenditure. If bilateral lenders were to withhold aid from heavy military spenders, these countries would no longer be able to draft a viable financing plan and would in turn be ineligible for structural adjustment lending.

But Landell-Mills also noted that local conflicts in the developing world have increased, not decreased, since the end of the cold war. Over the near term, he cautioned, there might well be more resources, not fewer, allotted to the military sector. Landell-Mills viewed the rising number of internal conflicts with particular alarm.

Yet even in the face of increased civil unrest, he was reluctant to see the World Bank or other institutions ignore the challenge posed by excessive military expenditure. He argued that the problem should be viewed as an aspect of governance. Military budgets should be subjected to the same scrutiny afforded other aspects of the national budget, he said, and public debates should be encouraged on the trade-offs between the different types of expenditures.

The panelists agreed that, whereas



Landell-Mills argued the absurdity of a world that spends 5 percent of GDP on the military.

the issue of excessive military expenditures was a prickly one—with numerous grey and sensitive areas—it was also a crucial one, and one that addressed the basic question of whether resources were being used wisely. Many of the issues impinged on matters of governance and, despite problems of determining what constituted excessive military spending, it was not, Ball argued, a matter of whether resources were being expended on imported arms or on maintaining a large army, but on whether military expenditure was too high relative to available resources and whether or not, as Landell-Mills noted, military expenditures were crowding out essential social spending.

IMF ACTIVITIES

The Gains from Latin America's Adjustment Must be Consolidated, says Camdessus

Following are excerpts from an address by Michel Camdessus to labor leaders from Latin America and the Caribbean on the "Social Dimensions of Economic Restructuring in Latin America and the Caribbean," delivered at the Inter-American Development Bank in Washington, D.C. on November 19, 1992:

Current Situation in Latin America and the Caribbean

You have already considered how, during the 1980s, development was severely undermined in Latin America and the Caribbean. Nevertheless, from 1990 onward there have been signs of substantial improvement in many of the major indicators. My IMF colleague has given you objective data showing that most countries in the hemisphere have returned to the path of economic growth, this time in a context of declining inflation and a sounder external position.

Camdessus: most countries of the hemisphere have returned to the path of economic growth.

We know well how much sacrifice and how much effort the governments and peoples of Latin America and the Caribbean have had to make in the past decade. This is why we cannot be content with the progress achieved so far and [cannot] consider the adjustment process over; nor can we return to policies which were disastrous in the past and would be disastrous in the future. Despite some striking figures, it may also be said that the deterioration of the 1970s and 1980s has barely been stanched. Much—indeed, much that is essential—remains to be done, first, to strengthen macroeconomic progress and, second, to ensure that it bears fruit in the form of improved conditions for the most disadvantaged, beginning with education, health, and housing; in economic management systems that meet such concerns as worker participation in the design of economic policy; and in a more equitable distribution of income, all of which have high priority.

Now that its first fruits are evident, the region's adjustment process must be carried further and deepened. It is a process that requires constant care and adjustment, as it is still highly vulnerable. A glance at the recent exchange crisis in Europe suffices to show that the quality of economic policies is the crucial factor, even in such seemingly stable and developed countries as those of Europe. My message today is therefore the following: let us make no mistake and let us not deceive ourselves; we must not let down our guard because the challenges of the global environment and the many tasks that must yet be tackled in the countries of the region require still greater clear-sightedness, greater firmness, and greater resolution.

The process of economic growth that Latin America is experiencing today must be measured not only in quantitative, but also in qualitative, terms. It must be growth that ensures a reasonable distribution not only of the cost of adjustment, but also of its benefits. To reach this goal, the IMF has given increasing attention to issues relating to poverty and social matters when advising countries on the design of their economic policy programs. Social measures must not be included in economic adjustment programs simply to make them more attractive; rather, they must be an *intrinsic component* of the overall strategy for economic adjustment. To achieve this will require not only reliable social safety nets; the economic measures themselves must be aimed at protecting the most vulnerable segments of the population. However, when [the measures] are actually oriented in this direction, . . . it must be recognized, for instance, that combating inflation is essential, not because of some monetarist idolatry but because it is basically an effort to combat a major social enemy. Until recently, there was talk of reducing inflation despite the potential human cost involved. Nothing could be further from the truth: Inflation must be reduced *precisely to avoid its social and economic cost!* Inflation is a stratagem used by societies to distribute the burden of adjustment blindly over the whole community—but the burden lands particularly on those who cannot escape it. Inflation is the harshest and most regressive of taxes and disproportionately affects those classes which are least well-off.

Reaching a Consensus

The improved macroeconomic policies prevailing in Latin America today are demonstrating concretely that, despite the inevitable cost of adjustment, the benefits are ample and tangible and offer the prospect of long-term development with a higher standard of living for people today and for generations to come.

But this progress cannot be achieved and sustained over time unless there is effective social dialogue, with the participation of governments, entrepreneurs, and the labor movement. The only guarantee of the durability of the progress achieved with so many sacrifices is the existence of a consensus at the very heart of each society on the need for, and the legitimacy of, a collective effort to achieve high-quality growth that, among many other things, benefits all, and particularly those whose need is greatest. There must be a clear understanding of what is at stake, of the range of available options, and of the equitable distribution of both the temporary costs of adjustment and its ultimate benefits.

Inflation is a strategem to distribute the burden of adjustment blindly. But the burden lands particularly on those who cannot escape it.

From this standpoint, the Latin American labor movement—traditionally so powerful and representative—has the duty and the right to advance its views, not only on matters related to labor and social problems, but also on the road to be followed by society as a whole. In our discussions with governments, we at the IMF have stressed the need for them to pursue actively the participation of the labor movement and other social partners in the task of defining each country's economic strategy.

Our experience at the IMF is that the increasingly representative political systems that have emerged in Latin America, Africa, and Eastern Europe in recent years have a greater capacity for launching and sustaining the necessary reforms. We must expand this process of democratizing social decisions, and the labor movement now has an excellent opportunity to express itself creatively on such topics as unproductive military spending, the role of the state and the efficiency of the public sector, the equity of the income distribution, corruption in government and other institutions, the safeguarding of human rights, and the quality of the environment. I am convinced that economic policies aimed at sustainable growth require what we call, for want of a better term, "good governance"—that is, accountable and active governments that enjoy the trust and support of their societies.

But it must be recognized that this task of yours is extraordinarily difficult, as is the task of enterprises and the task of governments. Their agendas would appear to be irreconcilable. But we all know full well that the challenge lies precisely in the reconciliation of these agendas: a challenge for you, for enterprises, and for governments. A challenge for leaders. Indeed, a challenge with historical significance. For your countries and for the hemisphere.

The legitimate concerns of the rest of society must of course be acknowledged: the concerns of government, which must find the financial and institutional means to achieve its aims of stability and economic development for all segments of society; the concerns of enterprises, which must at the same time face both the opening of their domestic markets and the need to compete on the world market despite infrastructural deficiencies and inadequacies, excessive regulation, low productivity, and, often, labor market rigidities; and the concerns of every member of society, who are entitled to demand that optimum use be made of the resources they generate [. . .] by bearing the tax burden.

This implies that no topics can be taboo in the negotiations among the social partners: they include those I have just mentioned, as well as others which, for you, are closer to home, such as wage indexation, rigid hiring rules, and labor mobility. At the same time, however, your task is to protect workers' rights effectively. This increases the difficulty of your work and requires strong leadership from you, from enterprises, and from governments as well. I believe this may be summarized by saying that *the success of some cannot be lasting unless it is the success of all*.

For us, the best way to help is to join efforts to ensure growth, to ensure that it is sustained over time, and to ensure that it has an increasingly strong social content. We are doing our utmost to this end, together with our friends at the IDB [Inter-American Development Bank]. They are on the front line of this task, and what I hear about the social emphasis which the IDB is giving to its work seems highly promising to me. But none of this will go very far without your work and without a truly effective dialogue within your countries. You may be sure that we at the IMF will continue trying to give ever more support to this process.

From The Executive Board . . .

Pakistan: Emergency Assistance. The IMF has approved a request by Pakistan for emergency assistance equivalent to SDR 189.55 million (about $262 million) to help it meet its immediate foreign exchange requirements in the wake of floods that caused widespread destruction in the country during September of this year.

Although comprehensive information is still being compiled, it is clear that the floods inflicted significant human hardship and physical destruction. Some thirteen hundred people died in the disaster, and an estimated nine million people were directly affected, mainly through damage to about a million houses in 13,000 towns and villages. There was also heavy damage to livestock, crops, and other physical assets.

The Pakistan Government's immediate policy response to the flood damage emphasized emergency rescue operations, provision of food and temporary shelter, and containment of the risks of disease. This is being followed by the implementation of a comprehensive relief and rehabilitation effort that has been formulated to be consistent with the authorities' ongoing reform and adjustment program. This program, which has been supported by the IMF under the structural adjustment facility (SAF—a concessional IMF lending facility for assisting low-income members that undertake economic reform programs to strengthen their balance of payments and improve their growth prospects; SAF loans have an interest rate of 0.5 percent, and are repayable over ten years with a five-and-a-half-year grace period) has already had beneficial effects on the economy. Its objective is to establish the conditions for high economic growth over the medium term in the context of domestic and external financial stability. Such a sound macroeconomic framework would provide a strong basis for sustainable improvements in Pakistan's social and environmental conditions.

Pakistan joined the IMF in July 1950, and it has a quota (a member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of SDRs) of SDR 758 million (about $1.05 billion). Its outstanding financial obligations to the IMF currently total the equivalent of SDR 655.3 million (about $904 million).

Press Release No. 92/83, November 25

Tanzania: ESAF. The IMF has approved a loan equivalent to SDR 64.2 million (about $89 million) for Tanzania to support the second annual arrangement under the enhanced structural adjustment facility (ESAF). (The ESAF is a concessional IMF lending facility for assisting low-income member countries undertaking economic reform programs to strengthen their balance of payments and improve their growth prospects. Loans under the ESAF carry an interest rate of 0.5 percent and are repayable over ten years, with a grace period of five-and-one-half years.) The IMF approved a three-year ESAF program totaling SDR 181.9 million (about $253 million) in July 1991, and Tanzania received loans totaling SDR 53.50 million (about $74 million) to support the first annual program.

During 1991/92, the authorities introduced a number of structural reforms to eliminate distortions stemming from two decades of central planning. These reforms were designed to open the financial sector, liberalize interest rates, reform the public enterprise sector, and continue the liberalization of the agricultural marketing system. Considerable strides were also made in establishing a market-oriented exchange and trade system, with the result that during 1991/92, Tanzania's economy grew by almost 4 percent. However, despite these reforms, the rate of inflation averaged 21 percent, and the external payments position remained fragile.

The economic program for 1992/93, framed in the context of the Government's medium-term policy, aims to raise the rate of economic growth to 5 percent, reduce the rate of inflation to 12 percent, and increase the level of foreign reserves to the equivalent of four months of imports. To these ends, the exchange regime will be further liberalized, the tax system will be rationalized and the revenue base broadened, and fiscal and monetary policies will be restrained.

Under the 1992/93 program, the financial sectors will be reformed: new private financial institutions will be licensed by the Bank of Tanzania, and commercial banks will be restructured. A comprehensive reform of the parastatal sector will be undertaken, with the objective of privatizing the majority of commercial public enterprises over the next five years and improving the efficiency of those remaining under state control. As part of exchange and trade reform, the operations of the foreign exchange bureaus will be strengthened, the import regime will be liberalized, and procedures and regulations governing the export sector will be simplified.

The authorities attach importance to maintaining adequate social sector expenditures, particularly in health and education. The medium-term program includes measures to cushion the impact of adjustment on the most vulnerable groups and, in this regard, the Government will increase its efforts to rehabilitate rural transportation infrastructure and expand the access of the rural population, particularly women, to agricultural services. It will also ensure that compensation packages and retraining are made available to those affected by retrenchment in the public sector.

Tanzania joined the IMF on September 10, 1962, and its quota is SDR 146.9 million (about $204 million). Outstanding financial obligations to the IMF resulting from past operations and transactions currently total SDR 128.4 million (about $178 million).

Press Release No. 92/84, November 25

Uganda: ESAF. The IMF has approved an additional loan equivalent to SDR 39.84 million (about $55 million) for Uganda under the enhanced structural adjustment facility (ESAF) to support its fourth annual economic reform program. The new loan follows disbursements of SDR 179.3 million (about $248 million) to Uganda since April 1989 under the ESAF.

Under the ESAF-supported programs, Uganda has made considerable progress in

reducing macroeconomic imbalances and strengthening its productive base by implementing strong structural reforms. The economy grew at an annual average rate of 4.7 percent from 1989 to 1991, the inflation rate decelerated considerably, and the external sector improved significantly. Despite these major achievements, Uganda continues to experience economic difficulties. An unfavorable external environment, characterized by the prolonged weakness in the export price of coffee, continues to hinder economic performance, which is further constrained by structural weaknesses that result from the high dependence on the coffee sector and the narrow revenue base.

The reform program for 1992/93, supported by the new ESAF loan, aims to achieve a real economic growth rate of at least 5 percent, reduce the inflation rate to 15 percent, narrow the overall balance of payments deficit, and raise the level of foreign reserves of the Bank of Uganda.

To these ends, fiscal policy will be restrained and underpinned by strengthened expenditure management and improved revenue collection. Monetary and credit policies are designed to reduce the rate of inflation sharply and will be supported by a major liberalization of interest rates. In the external sector, the authorities intend to unify the exchange rate system during the year and to continue to liberalize trade. Other structural reforms under the program include a continuation of civil service reform that involves rationalizing ministries and departments, and further restructuring the parastatal sector. The authorities also intend to increase substantially the level of expenditure on education and health, to target it more efficiently, and to institute reforms in these sectors.

As a result of improved security, the program includes a substantial reduction in

Currency Units per SDR

Currency	OCTOBER 30	2	3	4	5	NOVEMBER 6	9	10	11	12
Deutsche mark	2.16095	2.16884	2.1867	2.18788	2.20149	2.20404	2.20867	2.20888	2.20882	2.20187
French franc	7.33203	7.37914	7.41112	7.39265	7.43616	7.45174	7.49575	7.48896	7.47957	7.43132
Japanese yen	173.213	173.034	...	172.298	170.714	171.091	171.395	171.62	171.567	171.935
Pound sterling	0.89808	0.894045	0.905316	0.89874	0.903889	0.904898	0.90640	0.911008	0.912801	0.911319
U.S. dollar	1.40595	1.39995	1.39484	1.39844	1.39018	1.39025	1.38957	1.38341	1.38408	1.38857
Argentine peso	...	...	...	...	...	...	...	...	...	...
Australian dollar	2.02179	2.02086	2.0110	2.01021	1.9939	1.99883	1.99278	2.00691	1.99292	2.0014
Austrian schilling	15.1955	15.2263	15.2829	15.30	15.4885	15.4874	15.5389	15.544	15.5238	15.4741
Bahrain dinar	0.526837	0.526391	0.524385	0.525813	0.522708	0.522734	0.520782	0.520182	0.520414	0.52135
Bangladesh taka	54.8321	54.5981	54.381	54.5392	54.217	54.2198	54.0372	53.953	53.9791	54.0762
Belgian franc	44.3529	...	45.148	44.9668	45.1218	45.343	45.4467	45.5873	...	45.223
Brazilian cruzeiro	11160.3	...	11294.5	11269.4	11417.5	11544.9	11673.5	11874.5	13012.	13003.8
Canadian dollar	1.74199	1.7375	1.73159	1.74176	1.72867	1.74115	1.74457	1.74018	...	1.75139
Colombian peso	1115.83	...	1107.47	1111.21	1105.6	1109.18	1103.12	1102.04	1103.15	...
Danish krone	8.29511	8.3178	8.42153	8.38994	8.41884	8.46867	8.46732	8.4803	8.41739	8.43104
Finnish markka	6.9648	6.94576	6.93873	6.98732	6.99112	6.94152	6.95419	6.96895	6.96833	6.92037
Greek drachma	280.093	280.753	283.767	283.562	284.	285.279	285.594	285.477	284.927	285.796
Indian rupee	36.4	36.2447	36.1072	36.2056	35.9918	35.9936	35.8734	35.8100	35.8338	35.8983
Indonesian rupiah	2862.2	2860.9	2861.0	2868.2	2862.65	2852.79	2844.59	2841.52	2841.52	2846.63
Iranian rial	92.3	92.3	92.3	92.3	92.3	92.2	92.3	92.3	92.3	92.3
Iraqi dinar	0.43705	0.436195	0.435534	0.434715	0.432148	0.432100	0.430715	0.430043	0.430251	0.431035
Irish pound	0.826849	0.826366	0.829748	0.827239	0.832294	0.833863	0.833874	0.834435	0.83293	0.831227
Italian lira	1047.4	1057.88	1072.18	...	1061.41	1066.06	1066.36	1066.76	1067.33	1067.59
Korean won	1169.16	...	1089.75	1083.58	1087.12	1087.73	1083.52	1082.57	1083.04	...
Kuwaiti dinar	...	0.415861	0.414933	0.416864	0.413287	...	0.412803	0.412882	0.412282	0.413004
Libyan dinar	0.41[illegible]36	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286
Malaysian ringgit	3.52855	3.51457	3.50798	3.51708	3.49589	3.49829	3.49661	3.49477	3.4948	3.49873
Maltese lira	0.455813	0.455676	0.456809	0.45946	0.456673	0.456236	0.456751	0.461675	0.458396	0.458674
Nepalese rupee	69.0341	68.7775	68.5511	68.7134	68.3607	68.3637	68.1638	68.0718	68.1082	68.2065
Netherlands guilder	2.43201	2.44781	2.4614	2.4572	2.47341	2.47885	2.48128	2.48792	2.48484	2.47752
New Zealand dollar	2.98082	2.97217	2.95342	2.9556	2.95005	...	2.92319	2.93697	2.93735	...
Norwegian krone	8.75211	8.82948	8.93685	8.89199	8.92089	8.97128	8.98681	9.09738	8.94048	8.95378
Omani rial	0.540588	0.538201	0.536239	0.5377	0.534524	0.534661	0.532752	0.531921	0.532179	0.532136
Pakistan rupee	35.5185	35.4372	35.3029	35.407	35.2874	35.2801	35.1705	35.2265	35.2436	35.446
Portuguese escudo	192.462	192.597	194.919	194.077	196.875	198.225	198.073	199.65	194.909	195.88
Qatar riyal	5.11768	5.09582	5.07648	5.09032	5.06076	5.06051	5.04347	5.03581	5.03805	5.04711
Saudi Arabian riyal	5.26528	5.24381	5.22293	5.23716	5.20672	5.20649	5.18696	5.18067	5.18238	5.1927
Singapore dollar	2.27581	2.27072	2.26509	2.27274	2.25893	2.26541	2.26444	2.26258	2.26269	2.26704
South African rand	4.1588	4.16415	4.15194	4.15127	4.14899	4.1489	4.15047	4.15872	4.14879	4.14688
Spanish peseta	153.579	154.72	155.872	155.595	157.299	157.967	...	159.077	158.022	157.481
Sri Lanka rupee	62.5929	62.3398	62.1312	62.3095	61.9325	61.9634	...	61.8863	61.7181	61.8133
Swedish krona	8.12217	8.15121	8.26484	8.23423	8.24605	8.28729	8.30608	8.31775	8.28919	8.27782
Swiss franc	1.92828	1.93236	1.9504	1.95152	1.97107	1.9818	1.98275	1.98727	1.98565	1.98751
Thai baht	35.669	35.5587	35.4378	35.4784	35.2967	35.3263	35.2489	35.2356	35.2248	35.2882
Trinidad and Tobago dollar	5.99823	5.96486	5.94104	5.95823	5.92364	5.92333	5.90339	5.89419	5.89705	5.90785
U.A.E. dirham	5.16124	5.13922	5.11972	5.13387	5.10335	5.10361	5.09843	5.0199	5.08998	5.0901
Venezuelan bolivar	107.706	107.368	107.039	107.47	107.018	106.91	106.589	...	...	107.113

Notes: 1. The value of U.S. dollar in terms of the SDR is the reciprocal of the sum of the dollar values, based on market exchange rates, of specified quantities of the first five currencies shown. The exchange rates used for this purpose are noon rates in the London foreign exchange market. When the London market is closed, noon rates in the New York market are used. Frankfurt fixing rates are used when the New York market is closed. 2. The value in terms of the SDR of each of the other currencies shown above is derived from that currency's representative exchange rate against the U.S. dollar as reported by the issuing central bank and the SDR value of the U.S. dollar, except for the Iranian rial and the Libyan dinar, the values of which are officially expressed directly in terms of the domestic currency units per SDR.

Data: IMF Treasurer's Department

the size of the military establishment over the three-year period 1992/93–1994/95, and the authorities will use the resulting savings to finance critical social and economic services. The authorities attach considerable importance to formulating a national family planning program, strengthening the role of women in the development of Uganda, and developing an efficient environmental policy. The medium-term program also includes measures to cushion the impact of structural changes on the most vulnerable groups.

Uganda joined the IMF on September 27, 1963, and its quota is SDR 133.9 million (about $186 million). Outstanding financial obligations to the IMF resulting from past operations and transactions currently total SDR 232.2 million (about $323 million).

Press Release No. 92/85, November 25

Burundi: ESAF. The IMF has approved a loan for Burundi equivalent to SDR 12.81 million (about $17.7 million) under the enhanced structural adjustment facility (ESAF) to support its economic and financial program for 1992/93. This is the second loan under a three-year ESAF credit equivalent to SDR 42.70 million (about $58.9 million), which the IMF approved in November 1991. A loan equivalent to SDR 12.81 million (about $17.7 million) has already been disbursed under the first annual ESAF-supported program.

Since adopting its ESAF-supported medium-term economic program in 1991/92, Burundi has undertaken important steps to improve fiscal efficiency, strengthen monetary policy, enhance external competitiveness, and liberalize the exchange and trade regime. The authorities introduced additional measures in early 1992 to strengthen the adjustment effort in the face of a difficult external environment stemming from the collapse in the world price of coffee, Burundi's main export. Despite this negative factor, the broad economic indicators moved positively in 1992, with inflation being reduced to less than 9 percent and the economy expanding by 5 percent. During the first annual ESAF program, significant reforms were implemented in the financial sector and in monetary management as well as in the external trade and payments system, and exchange rate management. Substantial private sector participation has been introduced in the key coffee sector and in the rest of the parastatal sector.

The Government's medium-term economic program through 1995 is designed to achieve the sustained, noninflationary economic growth necessary to improve standards of living and reduce poverty while substantially strengthening the country's external position. In this context, the program for fiscal year 1992/93 is designed to achieve real GDP growth of about 4 percent in both 1992 and 1993 while reducing the average inflation rate to about 6.5 percent in 1992 and 5.5 percent in 1993. To these ends, the overall deficit of the public sector will be contained to 10.3 percent and 9.3 percent of GDP in 1992 and 1993, respectively, through reductions in current expenditures and increases in revenue. In the area of structural policies, the program seeks to improve the efficiency of the public sector and broaden private sector involvement. Accordingly, the Government will intensify its efforts to privatize, liquidate, or rehabilitate public enterprises and strengthen financial discipline. It will also implement reforms in the legal and regulatory framework to enhance private sector activity.

Burundi joined the IMF in 1963. Its new quota—after the recent increase in quotas under the Ninth General Review of Quotas—will be SDR 57.2 million (about $78.9 million), and its outstanding financial obligations to the IMF currently total the equivalent of SDR 40.99 million (about $56.5 million).

Press Release No. 92/86, December 1

Mozambique: ESAF. The IMF has approved a loan for Mozambique equivalent to SDR 30.5 million (about $42 million) to support its third annual program under the enhanced structural adjustment facility (ESAF). The IMF approved a three-year ESAF credit for Mozambique in June 1990 equivalent to SDR 100.65 million (about $140 million), of which the country has already borrowed the equivalent of SDR 70.15 million (about $97 million) under the respective program for the last two years.

In 1987, Mozambique embarked on a structural adjustment program aimed at narrowing economic and financial imbalances and creating a market-oriented environment. The Government also sought to increase the efficiency of the public sector and the role of the private sector in the economy. The Government's recent programs have been supported by three annual arrangements under the structural adjustment facility (SAF) from the IMF in addition to the two annual ESAF arrangements, as well as by several structural policy-oriented credits from the World Bank. As a result of these structural adjustment programs, Burundi has made considerable progress in reversing economic decline and in improving key areas of economic management.

Mozambique's economic performance during 1991–92 was adversely affected by the drought in southern Africa. As a result, economic activity, which had expanded by 2.7 percent in 1991, is projected to contract by 1.4 percent in 1992. Shortages of locally produced foodstuffs caused the rate of inflation to rise to an estimated 50 percent during the year. During the first half of 1992, the external current account deficit before grants is estimated to have been smaller than programmed as exports continued to grow and imports, owing mostly to lower-than-programmed disbursements of external assistance, decreased. In the field of structural reforms, during the first half of 1992, the Government separated the commercial bank functions of the Bank of Mozambique and liberalized the trade and exchange rate systems.

The Government's economic program for 1992–93 is designed to return the economy to a path of sustainable growth and decelerating inflation and to deepen the economy's transformation to a competitive market system. The program aims to achieve real economic growth of 3 percent in 1993 and to slow the rate of inflation to some 29 percent by the end of the same year. To these ends, the program will seek

a strengthening of public finances, taking into account the adverse impact of the drought and the costs of demobilization and of holding national elections. Monetary policy will be consistent with reaching the objectives of the program and will be strengthened by financial sector reforms, which are expected to accelerate in 1993.

Structural measures under the program emphasize privatizing and rehabilitating public enterprises and restructuring the banking system. They also provide for targeted measures to cushion hardships for the poorest population groups by expanding employment and income-generating opportunities, especially in the agricultural sector; strengthening the safety net to help vulnerable households; and increasing the coverage and quality of basic social services.

Mozambique joined the IMF on September 24, 1984. Its new quota—after the recent increase in quotas under the Ninth General Review of Quotas—will be SDR 84.0 million (about $117 million), and its outstanding obligations to the IMF, including SAF and ESAF loans, currently total the equivalent of SDR 112.85 million (about $157 million).

Press Release No. 92/87, December 3

Photo Credits: All photos by Denio Zara and Padraic Hughes of the IMF.

SDR Rates

Week Beginning	Rate of SDR Interest and Charges (percent)
December 7	5.63
December 14	5.67

The rate of SDR interest and charges is calculated weekly, by reference to a combined market interest rate, which is the weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). The interest rates used are those that prevail each Friday. For the latest weekly rates call (202) 623-7171.

Data: IMF Treasurer's Department

Estonia Stabilizes Economy Through a Currency Reform

On September 14, 1992, Estonia entered into a 12-month stand-by arrangement with the IMF for SDR 27.9 million. The arrangement supports a stabilization and reform program designed to overcome the remaining legacies of the command economy and speed up the transition to a market economy. The program has two cornerstones: stabilization, which includes a major currency reform; and a series of structural reforms.

In the following article, Tapio Saavalainen of the IMF's European II Department discusses the economic problems Estonia was facing when it adopted the IMF-supported program; the policies it is pursuing under the program; its early experience in implementing them; and the tasks ahead.

Economic Transition

Estonia had begun to move toward a market system even before achieving independence in August 1991. It had nationalized several enterprises that had previously been under Soviet control, established a central bank, and set up a tax system similar to that in some industrial countries. Moreover, a private banking system was emerging, and price liberalization—which had started in late 1989—was well under way.

However, as a small, newly independent, open economy, Estonia was vulnerable to the economic turmoil that followed the collapse of the Soviet Union, with which it had strong trade links. Also, until its currency reform in June 1992, Estonia was part of the ruble area, leaving the economy open to monetary shocks from Moscow. Estonia's inability to insulate itself from these shocks was compounded by the legacy of central planning, which had created severe rigidities, suppressed economic incentives, and weakened its ability to respond flexibly to increasing external disturbances.

In this environment, Estonia suffered far more serious adjustment costs during the early phase of its economic transformation than did other reforming economies in Eastern Europe. After declining by 4 percent in 1990 and 12 percent in 1991, real GDP is expected to fall by another 25–30 percent in 1992. The cumulative contraction since 1989 is some 10–20 percentage points more than in Bulgaria, Czechoslovakia, Poland, or Romania.

Despite declining real output, prices soared. Consumer price inflation reached 210 percent in 1991 and accelerated to more than 1,000 percent in 1992. Two processes explain the price explosion. First, Estonia liberalized most prices in 1991 to improve the allocative efficiency of its economy. Second, the price of imported oil from Russia jumped to close to world market levels in early 1992. At the same time, Russia's price liberalization raised prices of other goods and raw materials imported by Estonia. Hence, to a large extent, Estonia's inflation in 1991–92 can be characterized as an adjustment to an increasingly deregulated domestic environment and to external price shocks, the effects of which were intensified by the lack of insulation from ruble inflation in the former Soviet Union.

Despite the abrupt fall in output, officially recorded unemployment remained low (under 1 percent of the labor force) in the first half of 1992, implying that a large "employment overhang" still exists in the Estonian economy. The cost of adjustment resulted in declining real incomes.

Nominal wages lagged behind inflation in both 1991 and 1992, generating a strong downward shift in real wages. By September 1992, the average real wage was 45 percent lower than it was at the end of 1991.

On the external side, Estonia's foreign trade was badly hurt by the economic disruptions in the former U.S.S.R.. Its traditional trade deficit turned into a surplus in 1991, owing mainly to declining imports. In the first few months of 1992, foreign trade virtually collapsed, as Russia suspended deliveries of fuels. Moreover, the increasing malfunctioning of the foreign trade payments system curtailed raw material deliveries. The lack of external financing and increasing cross-border payments arrears added to foreign trade problems. In the first half of 1992, Estonia's trade account was broadly balanced, although at a very low level.

Until the currency reform of June 1992, the scope for autonomous macroeconomic policies to reverse these trends was limited. Monetary policy remained dependent on the Gosbank in Moscow. The supply of ruble notes from Russia decreased, leading to a serious ruble cash shortage, which resulted in the extensive use of hard currency and sporadic delays in the payment of salaries and pensions. In the fiscal area, Estonia achieved some autonomy with the tax reform in 1990, which formally eliminated its dependence on budget allocations from Moscow. Thanks to the better responsiveness of the new tax system to inflation and buoyant corporate tax receipts, the general government fiscal position was in substantial surplus in 1991. Nevertheless, political instability and institutional weaknesses, mainly in tax administration and social security systems, prevented prudent fiscal planning: in practice, Estonia relied on cash rationing to run public finances.

Adoption of a Currency Board

After reforming its currency on June 20, 1992, the Government was in a better position to implement independent economic policies. It replaced the ruble with the new Estonian currency, the kroon, in the context of a "currency board" and fixed the exchange rate to the deutsche mark at the rate of EEK 8 = DM 1. The kroon was backed by gold and foreign exchange, and kroon bank notes and reserve deposits of banks were made freely convertible into deutsche mark at the fixed exchange rate.

Estonia: Key Economic Variables

	1990	1991	1992[1]
		(percent change)	
Real GDP	–3.6	–12.6	–26.3
Consumer price index	...	210.0	1,055.3
Average wage	26.1	98.3	528.7
		(percent of GDP)	
General government			
Revenue	35.8	39.0	46.8
Expenditure	32.9	33.9	45.2
Surplus	2.9	5.1	1.6

[1]Preliminary estimates.

Data: Estonian authorities; and IMF staff estimates

The currency board introduced market discipline into the Estonian financial market. The Bank of Estonia cannot interfere with the setting of interest rates in the banking system. Thus, market-determined interest rates have become the chief mechanism through which the demand and supply of foreign exchange and cash are equilibrated. Nor can the central bank lend to the Government, enterprises, or banks, except in the event of a general banking crisis or in the context of restructuring an individual bank. Even in such cases, only the excess external reserves of the Bank of Estonia (that is, reserves other than those of the currency board) would be used. This ensures that the currency board's support for the kroon will never be compromised and that the monetary base is always fully, or more than fully, backed by foreign exchange.

A comprehensive fiscal package that became effective on the same day as the monetary reform increased confidence in Estonia's new currency. The package comprised an increase in the single value-added tax rate to 18 percent from 10 percent; a consolidation of the previous three-tier corporate tax rate structure, with an average effective rate of 27 percent, to a single rate of 35 percent; and the introduction of a top rate of 50 percent on all monthly incomes in excess of ten times the minimum monthly wage of EEK 200. Overall, this package was expected to generate revenue equivalent to about 5–6 percent of GDP and to ensure a surplus of about 1 percent of GDP in the consolidated general government operations for the second half of 1992. To support the monetary and fiscal policies, the Government also announced, as part of the stabilization package, a tax-based incomes policy.

Economic Stabilization and Reform Program for 1992–93

With the currency reform and the supporting fiscal package, the authorities have laid a strong foundation for stabilizing the Estonian economy. However, because the economy was experiencing a severe contraction and inflation was still high, further measures were necessary to obtain the external financing needed to ensure a successful transition to a market economy and to set the stage for sustainable growth. To that end, the Government adopted a comprehensive economic program for the 12 months

from July 1, 1992 through June 30, 1993, whose two main objectives are macroeconomic stabilization and structural reform. The main elements of the program as regards stabilization are

- completion of the price reform to realign domestic prices with world prices and with domestic production costs;
- restrictive fiscal policies to support the credibility of the new currency and prevent crowding out of the emerging private sector;
- monetary discipline under the currency board arrangement to reduce inflation and to provide the economy with a strong nominal anchor;
- strict incomes policies to contain wage inflation; and
- further liberalization of the exchange and trade system to open the economy to global competition, raise efficiency, and encourage foreign capital inflows.

The program's principal structural reforms include

- an acceleration of privatization so as to raise productivity and stimulate savings and investment;
- financial sector reforms to enhance efficiency in financial intermediation;
- strengthening of the social safety net to protect the most vulnerable groups from excessive costs of transition;
- restructuring or closure of nonviable enterprises and banks; and
- establishment of a legal framework consistent with a market economy.

With the concerted implementation of these policies, it was expected that the fall in real output could be limited to 15 percent in the program period, with some resumption of growth during 1993.

With tight fiscal and monetary policies, supported by an incomes policy, the rate of inflation was targeted to decelerate to a single-digit annual rate by the end of the program period. Although the inflation rate during the program period is likely to exceed rates in Western Europe, the initial undervaluation of the kroon should ensure the maintenance of cost competitiveness in the tradable goods sector. To support this aim and to prevent excessive declines in purchasing power, the authorities set wage guidelines so that real wages would remain unchanged in the absence of unforeseen external shocks. On the external side, as a result of necessary import financing, the external current account would remain in deficit throughout the program period.

Early Indications

Economic developments four months after the adoption of the program suggest that it is on track. As expected, real output contracted further in the third quarter of 1992, reflecting lagged effects of declining real incomes owing to the terms of trade shock, the adjustment to the new relative price structure, and the continued disruptions of trade with the former U.S.S.R. However, the output decline leveled off during the quarter. Meanwhile, although officially recorded unemployment remained low, at about 1 percent of the labor force, the slack in the labor market has began to increase, and unemployment is likely to rise sharply in coming months as a number of enterprises close.

Recent price statistics are encouraging. Monthly inflation declined from 20 percent in the summer to 6.6 percent in September and 7.7 percent in October, roughly in line with the path envisaged in the program. Because part of this inflation resulted from further price liberalization, the core rate of inflation was significantly lower in these months. Nominal wages increased in line with consumer prices over the three-month period July–September, implying broadly unchanged real wages. Maximum wage increases announced in September and November were in line with the program's wage guidelines.

Fiscal policy has maintained its momentum and, despite higher-than-expected corporate tax arrears, the general government fiscal balance did not deteriorate in the third quarter of 1992. Monetary conditions have remained tight, and confidence in the currency board continues to be strong. Net international reserves (excluding gold)—an indication of the strength of the currency board—increased from $62 million at the end of June to $96 million by the end of October. The stock of broad money increased by only 5 percent over the three months that ended at the end of September, or substantially less than the rate of inflation. Domestic credit has remained broadly unchanged. Short-term nominal interest rates on loans have remained at about 50 percent in recent months, implying a move toward positive real interest rates on these loans if the slowdown of inflation continues as expected.

Positive developments have also been recorded in foreign trade. Most notably, after the currency reform, Estonia's share of foreign trade with industrial countries, which was negligible in previous years, increased to nearly 50 percent of the total by the third quarter of 1992. In particular, exports to the Scandinavian countries have increased rapidly.

Tasks Ahead

The new Government, which took office in October, has made a strong commitment to adhere to the stabilization and reform program. However, despite the promising start, the tasks ahead are demanding. The immediate task is to deal with strains in the banking sector. On November 17, the Bank of Estonia closed three major banks experiencing difficulties that stemmed mainly from the freezing of their deposits at the old Soviet foreign trade bank (*Vneshekonombank*) in Moscow and from nonperforming loans. A spe-

Estonia: A Country Profile

Estonia lies on the eastern shore of the Baltic Sea and is bordered by Russia to the east, and Latvia to the south. It is the smallest of the Baltic republics, in area (45,215 square kilometers) and population (1.6 million at the end of 1990). Sixty-two percent of its people are ethnic Estonians, while 30 percent are of Russian origin. An independent nation between the two World Wars, Estonia was integrated into the Soviet Union in 1944. It regained its independence on August 20, 1991. After adopting a new citizenship law and constitution, Estonia held its first general elections in September 1992. The new Parliament (*Riigikogu*) consists of 101 seats, with 52 representatives backing the newly appointed center-right coalition Government.

Industry accounts for about one half of Estonia's total output and agriculture for about one fifth. Recently, the country composition of Estonia's foreign trade has changed dramatically—almost 50 percent of external trade is now with industrial countries. Estonia's main exports are textiles, furniture, timber, and milk products.

cial commission has been formed to recommend early remedial measures.

Beyond this immediate task, the success of the stabilization program will depend largely on the results in the fight against inflation. In this respect, maintaining the budget in balance and strict incomes policies are the main challenges. Principal risks lie in the inertia of inflation expectations and tight monetary conditions implied by the currency board arrangement. The former, as was seen during recent wage negotiations, will make a successful incomes policy difficult to attain, and the latter will maintain pressure on the budget as the squeeze on bank credits will push enterprises to seek finance, as in old days, from the Government.

In the area of structural reforms, accelerating the privatization process and restructuring the enterprise and banking sectors are the key challenges. Here, the initial results are encouraging. A particularly important and urgent task is to improve the existing social safety net because the success in lowering inflation is bound to create unemployment in the short term. In the longer term however, provided sound economic policies continue, living standards should rise, particularly because Estonia's well-educated and potentially highly productive labor force could help attract substantial domestic and foreign investment.

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